BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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In the Matter of the Application of **Valencia Water Company** (U 342 W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service in Order to Realize Increased Annual Revenue of $3,470,000 in a Test Year Beginning July 2007 and $864,000, in an Escalation Year Beginning July 2008, and to Make Further Changes and Additions to Its Tariff for Water Service.	A.06-07-002 (Filed July 3, 2006)

COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON THE PROPOSED DECISION

MARCELO POIRIER

Attorney for the Division of Ratepayer Advocates

California Public Utilities Commission
505 Van Ness Ave.
San Francisco, CA 94102
Phone: (415) 703-2913
Fax: (415) 703-2262
Email: mpo@cpuc.ca.gov

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Pursuant to Rule 14.3 of the California Public Utilities Commission's ("Commission") Rules of Practice and Procedure ("Rules"), the Division of Ratepayer Advocates ("DRA") files its Comments on the Proposed Decision of Administrative Law Judge ("ALJ") Bemesderfer in Valencia Water Company's ("Valencia") application to increase rates. DRA's Comments will address legal, factual and technical errors in the Proposed Decision ("PD").

I. RETURN ON EQUITY

A. The Proposed Decision Adopts a Higher Return on Equity for Test Year 2007-2008 than Requested by Valencia

The Proposed Decision commits factual error by adopting a higher Return on Equity ("ROE") than requested by Valencia in its application. (Proposed Decision, pg. 2, 28 and 51.) In its application, Valencia requested a Return on Equity of 10.20%, not 11.75% for the Test Year 2007-2008. (Valencia's Application 06-07-002, pp. 9-10.) While DRA still generally objects to Valencia's requested of a ROE of 10.20% for Test Year 2007-2008, it notes the error in the

Proposed Decision adopting a ROE figure that is higher than that requested by Valencia in its application.

B. It is Factual and Legal Error to Adopt Valencia's Full Risk Premium

The Proposed Decision adopted Valencia's full recommended 90 basis point (0.9%) risk premium adjustment to the company's ROE. (PD, p. 28.) In addition to the fact that the Proposed Decision provides no justification for the adoption of the full 90 basis point risk premium, there are numerous factual and legal errors associated with the Proposed Decision's adoption of the various business and company-specific risks contributing to the 90 basis point risk premium.

1. It is Factual and Legal Error to Adopt a Small Company Risk Premium

Since the Proposed Decision cites no reason for adopting Valencia's requested small company risk premium, DRA assumes it is relying on Valencia's arguments for adopting a small company risk premium. (Exhibit Valencia 4, pp. 19-23.) However, Valencia's argument is legal error because it was based upon a settlement and because it ignores the mandate of decision ("D.") 04-01-051, which approved the transfer of indirect control of Valencia to Lennar Corporation ("Lennar"). Valencia's argument is also factual error because it was based on a flawed study of the ROEs smaller water utilities.

Valencia cited as precedent for its small company risk premium recommendation a settlement reached between DRA and Park Water Company ("Park") where a 30 basis point risk premium was allowed. (Exhibit Valencia 4, pp. 20-21; D.06-10-036.) The adjustment to Park's ROE was reached as a result of a settlement between DRA and Park. (Exhibit DRA 12, pp. 4-1 to 4-3; D.06-10-036.) Under Commission Rules, a settlement does not constitute precedent in any future proceedings. (Rules 12.5.) Therefore, it is legal error to adopt a small company risk factor recommendation based on a settlement.

Valencia's argument for a small company risk premium is legal error because it ignores the mandate of D.04-01-051 which approved the approved the transfer of indirect control of Valencia to Lennar. (D.04-01-051, Attachment B, p. 1.) When the Commission approved of the transfer of indirect control of Valencia from Newhall Land and Farming Company to Lennar, it did so on the condition that Lennar "ensure that Valencia has adequate capital to fulfill all of its public utility service obligations." (Id.) Although Valencia may be comparable in size to other small water companies like Park and Great Oaks, it is legal error to argue it faces the same level of risk as these small water companies because the Commission has mandated in D.04-01-051 that its parent company Lennar "ensure that Valencia has adequate capital[.]" (Id.) Lennar Corporation is a multi billion dollar company with hundreds of millions in revenues. (Exhibit DRA 12, p. 4-2.) The other small water companies do not have the Commission mandated backing of a strong parent company.

Valencia's argument for a small company risk factor is based on a study using factually incorrect data. Valencia's small company risk premium was in part based on a study previously conducted by its witness that smaller water utilities have a higher cost of equity than larger water utilities. (Exhibit Valencia 4, p. 21, Attachment Schedule TMZ-4.) One of the companies used as a comparable smaller Class A water utility in the study was San Jose Water Company ("SJWC"). (Id.) However, the inclusion of SJWC in the study as a comparable small Class A water utility is a factual error since SJWC is a large water utility serving over a million customers. The study's inclusion of SJWC renders its results flawed and, the Proposed Decision's adoption of a small company risk factor recommendation based on this flawed study is factual error.

2. It is Factual Error to Find Valencia Faces Additional Risk From Operating in California

Since the Proposed Decision cites no reason for adopting Valencia's risk premium based on risk from operating in California, DRA assumes it is relying on Valencia's arguments. (Exhibit Valencia 4, pp. 15-19.) Valencia substantiates the risk premium by claiming it faces a higher regulatory risk because it operates in California, citing, in part, a report by Regulatory Research Associates ("RRA"). (Exhibit Valencia 4, p. 15.) It is factual error to find Valencia faces additional risk from operating in California based on RRA's report. RRA's evaluation of California's regulatory climates is not applicable since RRA's deals strictly with energy utilities. (Exhibit DRA 12, pp. 4-3 to 4-4.)

The Proposed Decision also fails to note that under the Commission's Water Action Plan ("WAP") the Commission is currently considering new regulatory mechanism that may lower water utilities' business risks such as a Water Revenue Adjustment Mechanism and Distribution System Improvement Charge.[1] (WAP, pp. 9, 12.) Regulatory risk also will be reduced since the Commission will be considering streamlining the regulatory process for water utilities under the WAP. (Id., pp. 18-19.)

3. It is Factual Error to Provide a Risk Premium to Valencia for Risks Faced by All Water Utilities

Since the Proposed Decision cites no reason for adopting Valencia's risk premium, DRA assumes it is relying on Valencia's arguments. (Exhibit Valencia 4, pp. 23-29.) Valencia argues it requires a risk premium because it faces added company specific risks due to catastrophic events, the actions of "no-growth" groups, unexpected legal costs, and water quality litigation expenses. (Id.) It is factual error to adopt a risk premium based on these risks since these

[1] Water Action Plan, December 15, 2005, pp. 9 and 12.

risks are not company specific. The risks identified by Valencia are generic and are faced by all Class A water utilities in California. (Exhibit DRA 12, pp. 4-5 to 4-6.) The Proposed Decision also fails to note that water utilities can seek memorandum accounts to recover the costs associated with the type of risks cited by Valencia.

C. The Proposed Decision Fails to Justify its Rejection of DRA's Objections to Valencia's Adjustments to the Components of the Discounted Cash Flow and Risk Premium Models

The Proposed Decision fails to justify its acceptance of all Valencia's methodological adjustments to components of the Discounted Cash Flow ("DCF") and Risk Premium ("RP") model analyses despite DRA's objections. (PD, pp. 22-28.) Valencia's ROE analysis contained multiple adjustments to components of the DCF and RP models. (Exhibit Valencia 4, pp. 29-44.) DRA objected to these conceptual changes due to their unconventional nature and tendency to unreasonably inflate the resulting ROE. (Exhibit DRA 12, pp. 4-1, 4-7 to 4-9; Tr., vol. 3, pp. 263-264, DRA/Aslam.)

Valencia's methodological adjustments to the DCF and RP model analyses include: 1) inclusion of SV growth in formulating its estimates of sustainable growth used in the DCF model; 2) use of authorized ROE instead of actual earned ROEs in the RP model; 3) use of relationship between earned ROEs for water utilities and interest rates; 4) use of an average of DCF cost of equity estimates; 5) exclusion of historical growth from the DCF model; and 6) exclusion of dividend per share ("DPS") from its calculations of historical growth. (Exhibit Valencia 4, pp. 29-44.)

DRA detailed its objections to Valencia's methodological adjustments to the components of the DCF and RP model analyses. (Exhibit DRA 12, pp. 4-1, 4-7 to 4-9; Tr., vol. 3, pp. 263-264, DRA/Aslam.) Although the Proposed Decision points out several factual mathematical errors in DRA's DCF analysis (DRA addresses these alleged errors in section E below) it does not provide any

justification for the rejection of DRA's policy-based objections to Valencia's methodological adjustments to the DCF and RP model analyses. (PD, pp. 26-28.)

D. It is Legal Error to Consider Valencia's Equity Cost Analysis Based on a Gas Utilities Benchmark

The Proposed Decision's acceptance of Valencia's equity cost analysis is legal error because it contravenes the Commission's long standing precedent of rejecting the use of a gas utility benchmark to determine the equity cost of water utilities. (D.04-05-023, p. 52.)

In its application, Valencia submitted an equity cost analysis using DCF and RP models based upon both a water utilities benchmark *and* a gas utilities benchmark. (Exhibit Valencia 4, pp. 29-44, 45-51.) The Proposed Decision accepts Valencia's equity cost analysis in full, without any alteration, despite the Commission's long standing precedent of rejecting the use a gas utility benchmark to determine the equity cost of water utilities. (PD, p. 24, footnote 48, 28; D.04-05-023, p. 52.) The use of a gas utilities benchmark in an equity cost analysis results in a higher ROE than if the equity cost analysis used a strictly water utilities comparable group.

The Commission has "consistently and unequivocally rejected" the use of gas utility data to analyze the equity costs of water utilities in past decisions. (D.03-02-030, p. 64.) The Commission has repeatedly rejected the use of a gas utilities benchmark due to the significant differences between the gas and water industry in cost recovery and market risks. (D.05-12-020, p. 11; D.92-01-025, p. 23; 1990 Cal. PUC LEXIS 98, p. *44.)

Furthermore, the Proposed Decision provides no justification for its departure from the Commission's long-standing rejection of the use of a gas utilities benchmark to analyze the equity costs of water utilities. In summary, the acceptance by the Proposed Decision of an equity cost analysis based on a gas utilities benchmark is legal error. The Proposed Decision should adhere to the

Commission's long-standing precedent limiting the use of a comparable group limited to other water utilities when analyzing equity costs.

E. The Proposed Decision's Statement that "Rerunning the DRA analysis with Restating and Corrected Data Produced a Range of Required ROEs Between 11.63% and 12.01%" is Factual Error

The Proposed Decision's statement that "Rerunning the DRA analysis with Restating and Corrected Data Produced a Range of Required ROEs Between 11.63% and 12.01%" is factual error. (PD, p. 28.) The range of ROEs produced by the "rerunning" cited in the Proposed Decision is taken directly from Valencia's rebuttal testimony as indicated by footnote 62 on page 28 and does not reflect the differences between the ROE analyses of Valencia and DRA. (PD, p. 28, footnote 62.) Rerunning DRA analysis with corrected data produces an ROE of 9.57%.

As discussed previously, Valencia's ROE analysis includes various methodological adjustments to components of the DCF and RP model analyses to which DRA objects. (Exhibit Valencia 4, pp. 29-44; Exhibit DRA 12, pp. 4-1, 4-7 to 4-9; Tr., vol. 3, pp. 263-264, DRA/Aslam.) The ROE analyses of Valencia and DRA fundamentally differ due to the use of different components in the DCF and RP models. Running the analyses of Valencia and DRA with identical data will result in drastically different results.

When DRA reran its ROE analysis using the corrected data regarding the stock splits as indicated by Valencia Exhibit 33 and late-filed Exhibit 40, a ROE of 9.57% resulted as shown in the attachment to DRA's opening brief. (DRA's Opening Brief, Attachment 1, Table 2-8.) The Opening Brief was DRA's first opportunity to respond to the data in late-filed Exhibit 40.[2]

[2] Valencia served late-filed Exhibit 40 on 12/15/2006.

In summary, the statement that "Rerunning the DRA analysis with Restating and Corrected Data Produced a Range of Required ROEs Between 11.63% and 12.01%" is factual error. Rerunning DRA's analysis with corrected data produces an ROE of 9.57%.

F. The Proposed Decision's Finding for a 11.75% Return on Equity Fails to Satisfy the Legal Standard for Establishing a Just and Reasonable Rate of Return

The Proposed Decision fails to satisfy the legal standard for establishing a just and reasonable rate of return because it fails to consider the interest of the consumer when granting Valencia's request for a 11.75% ROE. The legal standard for setting the fair rate of return has been established by the United States Supreme Court as well as the California Public Utilities Code.

In the Bluefield Water Works case, the Supreme Court stated that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public, and set forth parameters to assess a reasonable return. (Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (1923) 262 US 679, 692-693.) That return should be:

> ...reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. (Id. at, 692-693.)

In 1944, the Supreme Court again considered the rate of return issue in the Hope Natural Gas Company case affirming the general principle that, in establishing a **just and reasonable rate of return**, consideration must be given to the interests of **both consumers and investors**. (Federal Power Commission v. Hope Natural Gas Company (1944) 320 US 591, 603, emphasis added.)

In addition, Section 451 of the Public Utilities Code states: "All charges demanded or received by any public utility….shall be just and reasonable." (Public Utilities Code § 451.) As indicated in Hope Natural Gas Company, a

determination of "just and reasonable" must balance the interests of both ratepayers and the utility. Hope Natural Gas Company, 320 US at 603.)

The Proposed Decision, however, appears to consider only the interests of the utility. The Proposed Decision adopts Valencia's full ROE recommendation of 11.75% without any alteration. (PD, p. 28.) By adopting Valencia's ROE recommendation in its entirety, the Proposed Decision ignores the interests of the consumer. In fact, the Proposed Decision contains no mention of "consumers" or "ratepayers" at all. Although the Proposed Decision identifies data errors in DRA's DCF analysis, it does not provide any justification for adopting all of Valencia's methodological approaches to the DCF and RP models as well as all of Valencia recommendations regarding a riskpremium, which results in a 90 basis point (0.90%) upward adjustment of the ROE.

Furthermore, the Proposed Decision ignores the considerable weight of multiple recent Commission decisions for water utility General Rate Cases ("GRC") where ROE was litigated. In the ten water utility GRC decisions since 2000 where ROE was litigated and not settled, the Commission adopted, on average, a ROE of 9.97%, with the adopted ROEs ranging from 9.78% to 10.25% as shown in Table 1 below. The ROE adopted in the Proposed Decision considerably exceeds the average ROE in litigated cases by 1.78%. This is a significantly above the range of ROEs for Class A water utilities that the Commission has found to be just and reasonable.

Table 1 – Litigated Return on Equity for Class A Water Utilities GRCs 2000-2007

Decision	Company	DRA Recommended ROE	Company Recommended ROE	Decision ROE
03-02-030	Cal American	9.97%	11.00%	10.25%
03-05-078	Suburban	9.04%	12.00%	9.84%
03-08-069	Apple Valley Ranchos	9.53%	12.00%	10.10%
03-12-039	Great Oaks*	9.28%	10.95%	9.78%
04-03-039	So Cal Water	9.41%	12.45%	9.90%
04-05-023	Cal American	9.48%	11.20%	9.79%
04-07-034	San Gabriel	9.43%	12.25%	10.10%
05-12-020	Apple Valley Ranchos	9.85%	11.60%	10.15%
06-01-025	So Cal Water	9.35%	11.30%	9.80%
PD	Cal American**	9.69%	11.60%	10.00%
	Average	**9.50%**	**11.64%**	**9.97%**
PD	**Valencia**	**9.57%**	**11.75%**	**11.75%**

* In Resolution W-4594, May 11, 2006 the Commission adopted a rate of return of 9.01% for Great Oaks with a capital structure of 66% equity and 34% debt. Although the Resolution does not list the adopted ROE, DRA estimates that it was approximately 9.82% based on Water Division's recommended cost of debt.

** Does not reflect the proposed decision's 50 basis point downward adjustment due to WRAM's reduction.

In *every one* of these decisions, the Commission adopted a ROE between the figures recommended by DRA and the water utilities, reasoning that such a figure was reasonable and appropriately recognized the business risk of the water utilities.

Additionally, in the fifteen water utility GRCs since 2000 where ROE was settled, the average settled ROE was 9.94%, with the settled ROEs ranging from 9.70% to 10.15% as shown in Table 2 below. The ROE adopted in the Proposed Decision significantly exceeds the average ROE in settled cases by 1.81%.

Table 2 – Settled Return on Equity for Class A Water Utilities GRCs 2000-2007

Decision	Utility	DRA Recommended ROE	Company Recommended ROE	Decision ROE
00-10-027	Dominguez Water	8.54%	10.67%	9.95%
01-04-034	San Jose Water	8.40%	11.75%	9.95%
01-08-039	Cal Water	9.39%	10.75%	9.80%
03-05-030	Valencia Water	9.72%	12.00%	9.72%
03-09-021	Cal Water	9.70%	10.75%	9.70%
03-12-040	Park Water	9.30%	11.00%	10.15%
04-08-053	So Cal Water	9.30%	11.75%	9.90%
04-08-054	San Jose Water	9.18%	11.50%	9.90%
04-09-041	California American	10.04%	10.70%	10.04%
05-07-022	Cal Water	9.61%	12.15%	10.10%
05-07-044	San Gabriel	9.40%	12.00%	10.10%
05-09-020	California American	9.40%	10.50%	9.85%
06-08-017	Suburban Water	9.57%	11.75%	10.00%
07-04-046	San Gabriel	9.00%	12.00%	9.90%
Pending	Golden State Region I	9.68%	11.20%	10.10%
	Average	**9.35%**	**11.36%**	**9.94%**
PD	**Valencia**	**9.57%**	**11.75%**	**11.75%**

By adopting Valencia's recommended ROE of 11.75% without any alteration, the Proposed Decision clearly ignores the legal standard established by the US Supreme Court in Bluefield Water Works and Hope Natural Gas Company affirming that consideration must be given to the interests of **both** consumers and investors when establishing a just and reasonable rate of return as well as the mandate of Section 451 of the Public Utilities Code. (Hope Natural Gas Company (1944) 320 US 591, emphasis added; PU Code § 451.) Granting an ROE of 11.75% will give Valencia over $793,000 in excess revenue requirement which is not just and reasonable based on recently adopted ROEs for other Class A water utilities.[3]

[3] DRA's calculation assumes a reasonable return is 10% for ROE resulting in a rate of return (ROR) for Valencia of 9.43% with the PD adopted capital structure. The PD's ROR of 10.61% for the 2007-2008 Test Year exceeds this reasonable level of ROR by 1.18%, which results in an a windfall of approximately $793,450 in additional revenue requirement for Valencia. (Rate Base $38,673,725 x 1.18% x Net to Gross Mult.

II. CAPITAL STRUCTURE

A. It is Factual Error that DRA's Recommended Capital Structure is Based on a Comparison with Large Companies

The Proposed Decision's incorrectly states that DRA's recommended capital structure is based on a comparison with large publicly traded water companies. (PD, p. 18.) DRA's capital structure comparison included both large and small water companies such as Park. (Exhibit DRA 12, p. 3-3.) Additionally, Park and Great Oaks Water Company are characterized as a small water company in Valencia's own testimony. (Exhibit Valencia 4, pp. 20-21; Exhibit Valencia 4, p. 6.)

B. The Proposed Decision's Rejection of DRA's Recommended Reduction of Valencia's Level of Preferred Stock is Based on Factual Error

The Proposed Decision's rejection of DRA's reduction in the level of preferred stock in Valencia's capital structure is based on the factual error that there is no cost difference between preferred stock and long-term debt. (PD, p. 20, footnote 32.) Although preferred stock and long-term debt function similarly, there is a significant difference in their cost for Valencia's ratepayers. The cost of Valencia's preferred stock is 9.50%, while the cost of Valencia's long-term debt is 8.00%, a 1.5% difference in cost. (Valencia Application, p. 10.) This higher cost supports DRA reduction of the level of preferred stock in Valencia's capital structure.

C. There is No Evidence on the Record to Support that Valencia's Rates are Moderate to Comparable Companies in the Region

DRA recommended that the Commission adopt an imputed capital structure for Valencia due to Valencia's high percentage of common equity. (Exhibit DRA 12, pp. 3-1.) Although the Proposed Decision recognized that Commission

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1.732=$793,450).

sometimes imputes a water utility's capital structure to keep water rates reasonable, it declined to follow DRA's recommendation based on the fact that "Valencia's rates are already moderate relatively to the rates of comparable companies in the region." (PD, p. 20, footnote 33.) The Proposed Decision fails to refer to any evidence on the record that identifies the comparable companies or their specific rates.

D. The Proposed Decision's Finding on Capital Structure Fails to Satisfy the Legal Standard for Establishing a Just and Reasonable Rate of Return

As discussed earlier, there is a long established legal standard requiring that consideration must be given to the interests of both consumers and investors when establishing a just and reasonable rate of return. (Hope Natural Gas Company (1944) 320 US 591, emphasis added; PU Code § 451.) The Proposed Decision fails to satisfy the legal standard for establishing a just and reasonable rate of return because it fails to adequately consider the interest of the consumer when adopting Valencia's request as to Capital Structure.

Valencia proposed a capital structure consisting of 27.95% long-term debt, 69% common equity and 3.05% preferred stock. DRA considered this capital structure burdensome to ratepayers since "[e]xcessive levels of common equity burden the ratepayer with excessive rates" and recommended an imputed capital structure consisting of 46.4% long-term, 52.6% common equity and 1% preferred equity. (Tr., vol. 3, pp. 244-247, DRA/Aslam; 1989 Cal PUC LEXIS 487, p. 22; Exhibit DRA 12, p. 1-2.)

The cost of common equity is higher than the cost of long-term debt and ratepayers must pay for that increased cost. In Valencia's service area there will be a considerable difference in cost to ratepayers, with Valencia requesting an 11.75% Return on Equity and an 8.0% Return on Debt. It is burdensome to ratepayers for the Commission to adopt a capital structure where nearly 70% that capital structure requires a return of 11.75%.

When compared to DRA's recommended capital structure and assuming the 11.75% ROE, the Proposed Decision's adopted capital structure results in an rate of return which is 0.61% higher with a revenue requirement impact of approximately $410,000.

Furthermore, the adoption of a capital structure with such a low level of long-term debt deprives the ratepayers of the substantial benefits of the tax deductions allowed for long-term debt interest payments. (1989 Cal PUC LEXIS 487, p. 22.) In the past, the Commission has adopted imputed capital structures for water utilities in several GRCs in order to reduce the burden on ratepayers.[4] An imputed capital structure with a lower percentage of equity ensures that the interests of ratepayers are considered when establishing just and reasonable rates.

III. BASE REVENUE MEMORANDUM ACCOUNT

A. It was Legal Error to Accept Valencia's Supplemental Testimony on the Base Revenue Memorandum Account Issue

The acceptance of Valencia's supplemental testimony on a Base Revenue Memorandum Account ("BRMA") was procedurally improper because the ALJ's Ruling did not call for additional testimony on new issues.

On October 4, 2006, the assigned ALJ issued a "Ruling Requesting Additional Information" directing Valencia to file a "response" as to whether its pending General Rate Case ("GRC") application "complies with the Water Action Plan/GRC check list distributed on July 19, 2006 to all Class A water companies by Kevin Coughlan, Director of the Commission's Water Division."[5] (ALJ's Ruling Requesting Additional Information, p. 1.) The ALJ's Ruling ordered Valencia to file a response that:

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[4] Great Oaks Water Company (Resolution W-4594, p. 8.); San Gabriel (D.04-07-034).

[5] DRA emphasizes that the Water Action Plan/GRC check list is not part of the Rate Case Plan adopted in D.04-06-018, and the schedule adopted for processing the rate cases does not take into account expanding the scope to new and complex issues in water general rate cases.

> …identifies the portions of its pending General Rate Case application in which the issues in Director Coughlan's July 19th checklist are addressed. To the extent that an issue on the checklist has not been addressed in the application, Valencia shall either **propose a procedure and schedule to address the issue** or show good cause why this issue need not be addressed as part of the General Rate Case. (Id., emphasis added.)

Valencia's response was due on October 13, 2006. (Id.) The ALJ's Ruling allowed DRA one week, or until October 20, 2006 to file its "reply" to Valencia's October 13 response. (Id. at 2.)

On October 13, 2006, Valencia served supplemental direct testimony which included information identifying the portions of its GRC application that address the issues in Director Coughlan's checklist. (Exhibit Valencia 23.*)* The supplemental direct testimony also contained testimony on a BRMA to decouple water sales from revenue, a new issue that was not included in the company's GRC application. (Id., pp.6-7.) A BRMA is a type of Water Revenue Adjustment Mechanism ("WRAM"), a ratesetting mechanism designed to remove the disincentives to conservation imposed by current ratemaking mechanisms. (I.07-01-022, p. 6.)

DRA served a timely reply to Valencia's to Valencia's October 13th document on October 20, 2006, stressing that the BRMA was a complex issue that should be considered in another phase of the proceeding or in another proceeding altogether. DRA did not serve testimony addressing this issue since the ALJ's Ruling clearly did not intend for DRA to do so, as is evident by its requirement for Valencia to propose a schedule for dealing with new issues.

Valencia's October 13, 2006 response should have been a legal pleading containing the additional information requested by the ALJ's Ruling and not additional testimony on a new issue. If Valencia's GRC application did not include information on a mechanism to decouple water sales from revenue, Valencia should have only proposed a procedure and schedule to address the issue, not serve new testimony on a new issue. It was procedurally improper to accept

Valencia's supplemental testimony on the BRMA, especially without providing a schedule that would provide DRA sufficient time to issue responsive testimony. Therefore, the Proposed Decision's granting of Valencia's request for a BRMA is legal error.

B. The Commission Failed to Proceed in a Manner Required by Law by Including the Base Revenue Memorandum Account Issue in this Proceeding

The Commission failed to proceed in a manner required by law by including the BRMA issue in the scope of the proceeding. According to the precedent set by the recently decided case, Southern California Edison Company v. Public Utilities Commission, the Commission's failure to comply with its own rules regarding the scope of issues to be addressed in this proceeding was prejudicial to DRA.[6] (Southern California Edison Company v. Public Utilities Commission, 140 Cal. App. 4th 1085, 1104.) The BRMA issue should not have been addressed in this proceeding without including the issue in a scoping memo for the proceeding and providing DRA with sufficient time to issue testimony in response to the proposal.

Rule 7.3 requires the Assigned Commissioner to issue a scoping memo in a proceeding and provide for objections to the preliminary scoping memo. A scoping memo determines schedule and issues to be addressed in a proceeding and the timetable for resolving the proceeding. (Rule 7.3(a).) No scoping memo was

[6]Southern California Edison Company challenged a decision of the CPUC that certain public utilities had to require the payment of prevailing wages to workers on energy utility construction projects. The prevailing wage proposal was an issue added after development of the PUC's scoping memo. The court held that the PUC had failed to proceed in the manner required by law in that it violated its own procedural rules. The PUC prejudicially failed to proceed in the manner required by law, Pub. Util. Code, § 1757.1, subd. (a), because: (1) the prevailing wage proposal was beyond the scope of issues identified in the scoping memo; (2) the PUC violated its own rules by considering the new issue; and (3) and three business days was insufficient time for the parties to respond to the new proposals. (Southern California Edison Company v. Public Utilities Commission, (2006) 140 Cal. App. 4th 1085.)

issued in this proceeding.[7] The requirement to issue a scoping memo is based in statute and cannot be waived. (P.U. Code § 1701.1(b)). The failure to issue a scoping memo in this proceeding and then expanding the scope of the proceeding to include issues beyond those included in Valencia's initial application without issuing a scoping memo is legal error.[8]

The BRMA was not part of Valencia's original GRC application. A scoping memo was never issued that included that included WRAMs within the scope of the proceeding. Even assuming, *arguendo* that despite the lack of the mandatory scoping memo, a scope of issues was implied by the issues included in Valencia's application, the BRMA issue included as a result of Valencia's supplemental direct testimony was still beyond the even any "implied" scope of the proceeding. The Commission did not amend the scope of the proceeding by issuing a scoping memo at the time of the ALJ's Ruling Requesting Additional Information.

DRA was prejudiced because it was never provided with an opportunity to issue testimony in response to Valencia's BRMA proposal.[9] Excluding the weekend, the time allowed for DRA to respond to the merits of the BRMA was only five business days. Five business days was not sufficient time for DRA to review and draft testimony on the proposed BRMA. As with the issue in Southern California Edison Company, the BRMA is a complex issue that involves "issues of public policy, economic effects, legal implications, and effective administration and implementation[.]" (Southern California Edison Company, 140 Cal. App. 4th at 1106.)

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[7] Under Rule 7.3(b), the assigned Commissioner has the discretion not to issue scoping memo in some instances. This proceeding is not such an instance. Timely protests were filed and evidentiary hearings were held.

[8] Although it was legal error not to issue a scoping memo, DRA takes issue only with expanding the scope of the proceeding to include the BRMA issue.

[9] As discussed in the previous section, the ALJ's October 4, 2006 Ruling never intended DRA to issue testimony as part of its October 20 Reply, only to reply to Valencia's response to the ALJ's Ruling for additional information.

The complexity of a WRAM is evidenced by the Commission's recently issued Order Instituting Investigation ("OII") to consider policies to achieve the Commission's conservation objectives for Class A water utilities. (I.07-01-022.) One of the main objectives of the OII is to investigate WRAMs. (Id., p. 6.) The BRMA is far too complex an issue to expect that five working days would be sufficient time to thoroughly analyze and draft testimony on the issue.

In summary, the BRMA was beyond the scope of issues in the proceeding, the Commission violated its Rules by considering the new issue, and five business days was insufficient time for DRA to review and draft testimony on the BRMA proposal. The Commission's failure to comply with its own rules concerning the scope of issues to be addressed in the proceeding was prejudicial and legal error. Therefore, the Proposed Decision should not allow Valencia to establish a BRMA.

C. The Proposed Decision's Adoption of the Base Revenue Memorandum Account is Technical and Legal Error

The Proposed Decision's adoption of the BRMA is technical and legal error. Valencia's BRMA has several technical and legal flaws. First, in order to decouple sales from revenue, the Commission would have to adopt a mechanism that balances adopted revenues with actual revenues. However, Valencia's proposed BRMA appears to balance adopted revenues with actual cost. Balancing adopted revenue with actual cost is problematic because: 1) it removes any incentive for Valencia to operate under the Commission's approved cost structure; and 2) constitutes retroactive ratemaking because it allows recovery in a future period of costs beyond those adopted by the Commission (the adopted revenue requirement). (P.U. Code § 728.)

Second, even if the proposed BRMA balanced adopted revenues to actual revenues as opposed to adopted revenues to actual cost, Valencia's proposal still usurps Commission authority. Valencia stated in its supplemental testimony regarding the BRMA that it anticipates growth. (Exhibit Valencia 23, p. 8.) The

Commission has not determined whether service areas with growth should have decoupling mechanisms that balance total versus per capita/per customer adopted revenues to actual revenues.

Furthermore, Valencia's BRMA proposal was inadequate in terms of its detail. The BRMA proposal consisted of a barely two-page attachment to its supplemental testimony. (Id.) The BRMA proposal lacked the requisite detail to determine whether it would effectively decouple water sales from revenues. Additionally, it was not presented in sufficient detail for DRA to evaluate if the BRMA is fair to ratepayers.

In summary, the Proposed Decision commits legal and technical error by approving Valencia's BRMA proposal because of various problems with the design of the BRMA. DRA recommends that the Commission not approve Valencia's BRMA and that it instead order Valencia to file a separate application to request a mechanism that decouples sales from revenues as well as to address other issues identified in the OII to consider policies to achieve the Commission's conservation objectives for Class A water utilities. (I.07-01-022.)

IV. ADDITIONAL FACTUAL ERRORS

DRA noted a number of factual errors contained in the Proposed Decision. DRA recommends the following changes to correct these factual errors:

- The entire caption on page 1 of the Proposed Decision is incorrect. It is different from that used in Valencia's Application and subsequent filings. (Valencia's Application 06-07-002, p. 1.)[10]

~~In the Matter of the Application of VALENCIA WATER COMPANY (U-342-W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service in Order to Realize Increased Annual Revenues of $2,402,000 in a Test Year Beginning July 2007, $708,000 in a Test Year Beginning July 2008, and $660,000 in an Escalation Year Beginning July 2009, and to~~

[10] Additions are underlined and text that should be deleted is shown with ~~strikethrough~~.

~~Make Further Changes and Additions to Its Tariff for Water Service.~~

The caption should read:

In the Matter of the Application of **Valencia Water Company** (U 342 W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service in Order to Realize Increased Annual Revenue of $3,470,000 in a Test Year Beginning July 2007 and $864,000, in an Escalation Year Beginning July 2008, and to Make Further Changes and Additions to Its Tariff for Water Service.

- On pages 8 and 13, the Proposed Decision incorrectly asserts that hard water corrodes pipes. The compounds in hard water precipitate out and attach themselves to surfaces of pipes, clogging the pipes. (See Exhibit Valencia 36, p. 6.)
- On page 8 and in Finding of Fact 5, the Proposed Decision incorrectly asserts that all in-home water softeners discharge chlorides into the sewer system. Only the Self-Regenerating type of water softeners used by some of Valencia's customers produce a chloride discharge. (Exhibit Valencia 8, p. 5.)
- On page 13 of the Proposed Decision, Footnote 18 uses a figure of "28,3000" customers in a calculation. The correct figure is 28,300.
- Finding of Fact 3 states that a majority of Valencia's customers find the water unacceptably hard. Although majority of Valencia's customers in the survey "perceived the local water to be 'Harder' than other communities in Southern California", the survey results did not ask whether the local water was "unacceptably" hard. (Exhibit DRA 10, p. 23.)
- On page 19, the Proposed Decision incorrectly categorizes Class B water utilities as having 500 to 10,000 connections. The correct number of connections for Class B water utilities is 2,001 to10,000. (WAP, p. 3, Footnote 1.)

- Finding of Fact 10 incorrectly asserts that the "removal of the home water softeners would reduce the need for additional wastewater treatment facilities." The removal of the only the Self-Regenerating type of home water softeners would reduce the need for additional wastewater treatment facilities. (Exhibit Valencia 8, pp. 32-34.)
- On page 22, the Proposed Decision incorrectly asserts that Valencia's analysis of the cost of equity was limited on a study of benchmark water utilities. Valencia's analysis of the cost of equity was based on studies of both benchmark water utilities and benchmark gas utilities. (Exhibit Valencia 4, pp. 29, 45.) (Also see the discussion in section I.D. above, addressing the error of including gas utilities in this analysis.)

V. CONCLUSION

DRA recommends that the Commission modify the Proposed Decision as discussed above. Unfortunately, the Proposed Decision contains numerous legal, factual and technical errors that require correction. As written, the Proposed Decision contains far too many legal, factual and technical errors to withstand either internal or appellate scrutiny.

Respectfully submitted,

/s/ MARCELO POIRIER

Marcelo Poirier
Staff Counsel

Attorney for the Division of Ratepayer Advocates

California Public Utilities Commission
505 Van Ness Ave.
San Francisco, CA 94102
Phone: (415) 703-2913
Fax: (415) 703-2262

May 29, 2007

ATTACHMENT A

CHANGES TO FINDINGS OF FACT AND CONCLUSIONS OF LAW[11]

Findings of Fact

3. A majority of Valencia's customers find the water ~~unacceptably~~ hard.

5. The Self-Regenerating type of home water softeners periodically discharge brine into the wastewater system and ultimately into the Santa Clara River.

10. Removal of the Self-Regenerating type of home water softeners would reduce the need for additional wastewater treatment facilities.

15. Valencia is not a small water company. ~~notwithstanding its ownership by a large real estate development company.~~

~~16. Small water companies typically have higher costs of capital than large water companies.~~

17. ~~California water companies face greater regulatory risk than companies located outside California.~~

18. ~~Valencia faces continually-threatened litigation and other company risks.~~

19. Valencia should not receive an equity risk premium because it faces no higher risk than other water utilities regulated by the Commission. ~~An equity risk premium of 0.9% is appropriate for Valencia~~.

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11 Additions are underlined and text that should be deleted is shown with ~~strikethrough~~.

35. A balanced capital structure is less burdensome to ratepayers.

36. The cost of common equity is higher than the cost of long-term debt.

37. The cost of preferred stock is higher than long-term debt to ratepayers.

Conclusion of Law

1. ~~Valencia's construction of a demonstration pellet softening plant is in the public interest.~~

2. Valencia's capital structure for ratemaking purposes should be ~~its actual capital structure~~ imputed at a level comparable to other regulated water utilities in California.

3. A rate of return of ~~11.75%~~ 9.57% on common equity is supported by the record and in the public interest.

10. Implementation of a ~~A~~ Base Revenue Memorandum Account ~~is a reasonable means of removing disincentives to water conservation~~. was not included in the scope of this proceeding and therefore cannot be addressed at this time.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON THE PROPOSED DECISION** in **A.06-07-002** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on May 29, 2007 at San Francisco, California.

/s/ JANET V. ALVIAR
Janet V. Alviar

NOTICE

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address and/or e-mail address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

* *

Service List
A.06-07-002

bjohnson@valencia.com;
flc@cpuc.ca.gov;
gmilleman@valenica.com;
kjb@cpuc.ca.gov;
llk@cpuc.ca.gov;
mmattes@nossaman.com;
mpo@cpuc.ca.gov;
rdiprimio@valencia.com;
vcc@cpuc.ca.gov;